Raising financial capital

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Objectives:

- Planning your funding strategy – key questions
- Appropriate funding sources
- The ‘Valley of Death’
- Valuing new ventures
- Structuring equity investments
- Sources of equity – Venture Capital

The bootstrapper's mantra….

"Never buy new what can be bought second-hand

Never buy what can be rented

Never rent what can be borrowed

Never borrow what can be begged

Never beg what can be salvaged"

Attributed to the late Jeff Timmons

Planning your funding strategy: Key Questions

1. The ‘type’ of business you are starting; because this affects the type of money you can access

2. Your attitude towards growth and to sharing ownership and control

3. What ‘stage of development’ our business is at

4. The risks involved and the returns expected by financiers

5. The rate at which your business will consume cash (the Burn Rate) and whether/when you are likely to run out of cash

6. Your bargaining power relative to the providers of capital

W~~H~~ealth Warning

Do not try to finance your business with debt until you have reliable cash flow from sales…

Stage of Venture Development and Funding

Initial Ideas → Feasibility → Prototyping → Commercialisation

Consultancy or other earned income to live on

Own cash; friends, family & fools

Grants (NESTA, Govt., EC etc)

Business Angels, Regional Tech Funds

Venture Capital

Bank Loan

Real Sales! →

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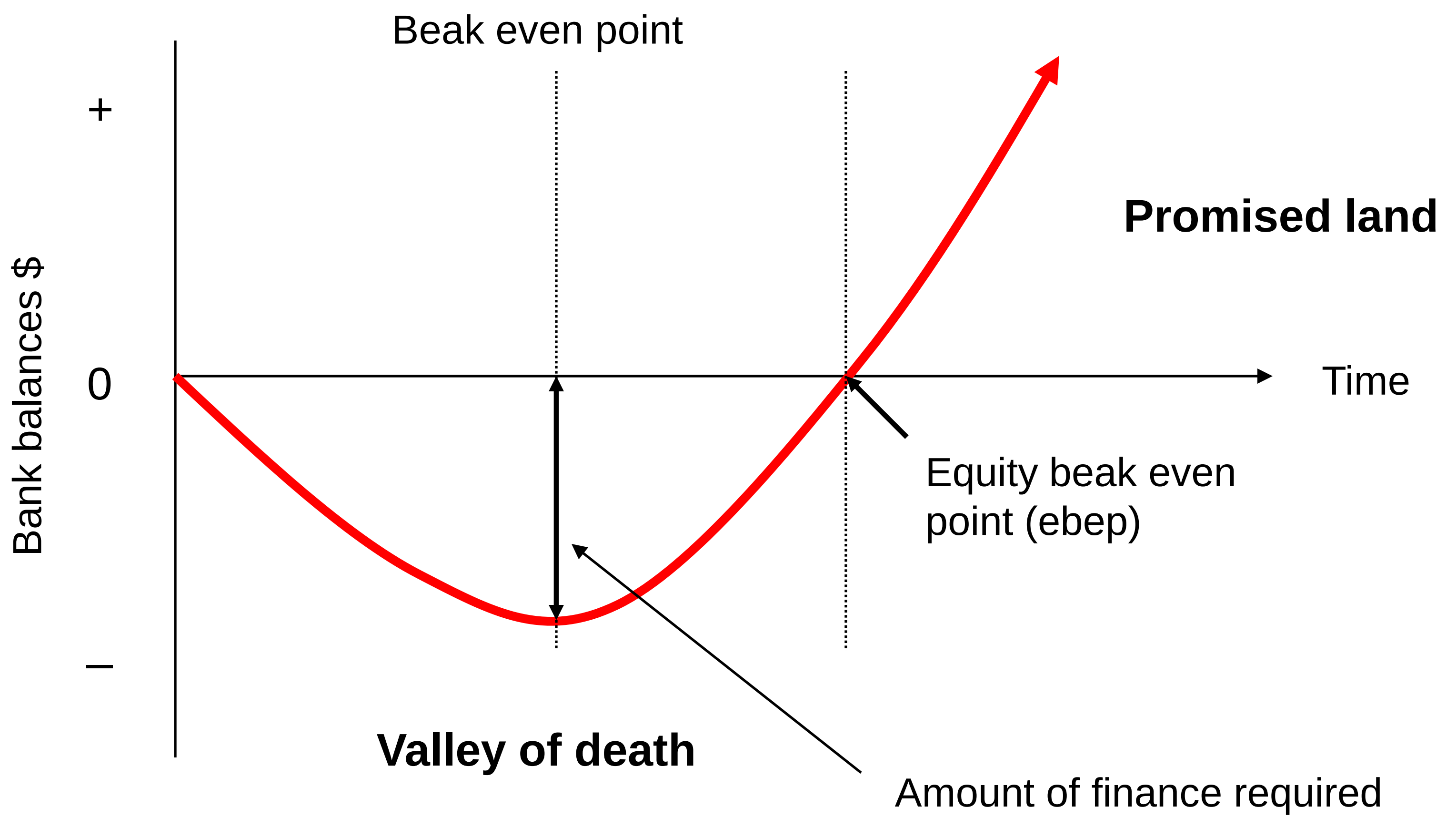
Financing the journey to the promised land



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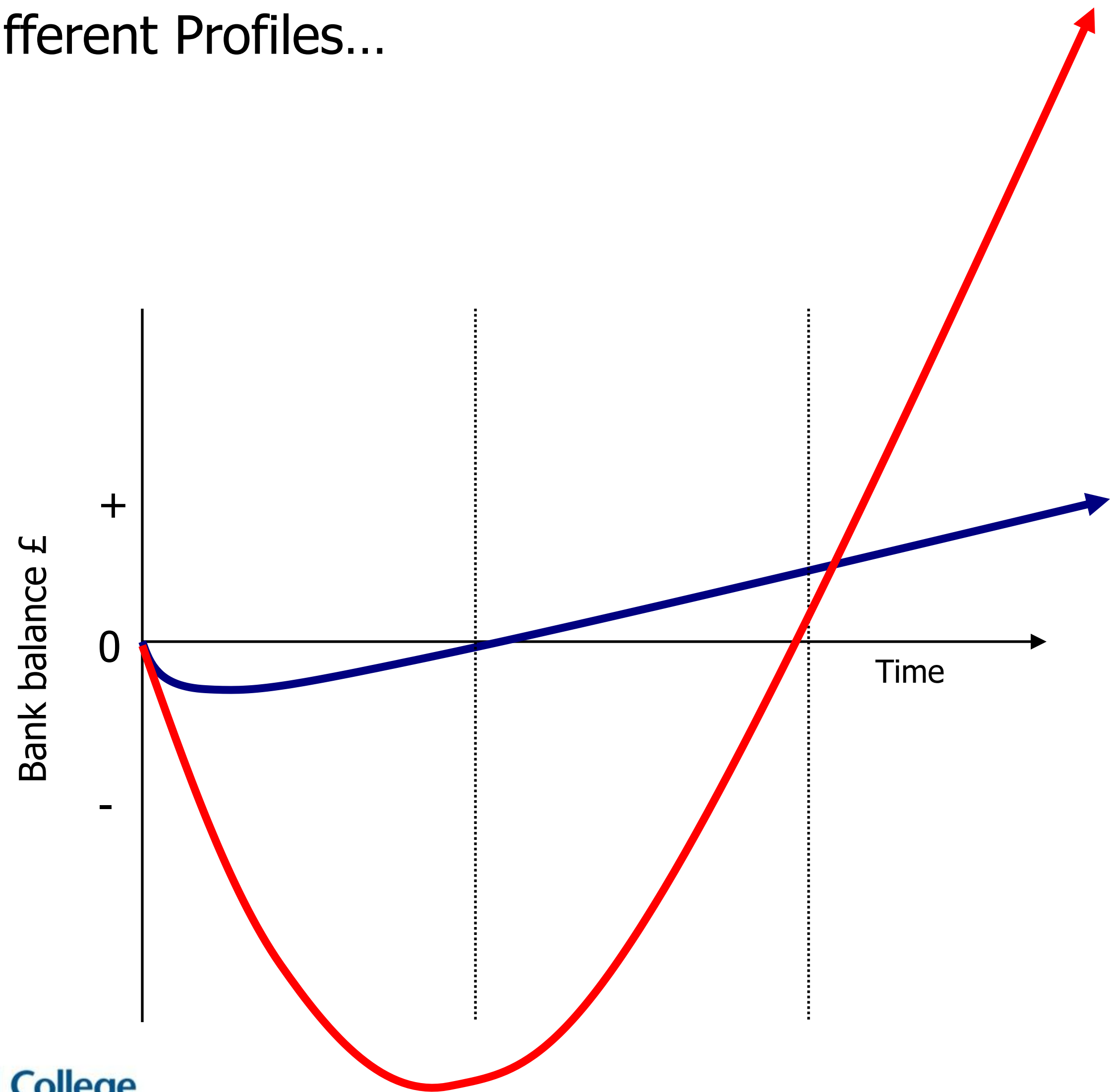
Different Firms,
Different Profiles…



Technology firm

- Large investment required
- Late break-even
- Huge upside (Microsoft)

Consulting firm

- Low investment required
- Early break-even
- Modest upside

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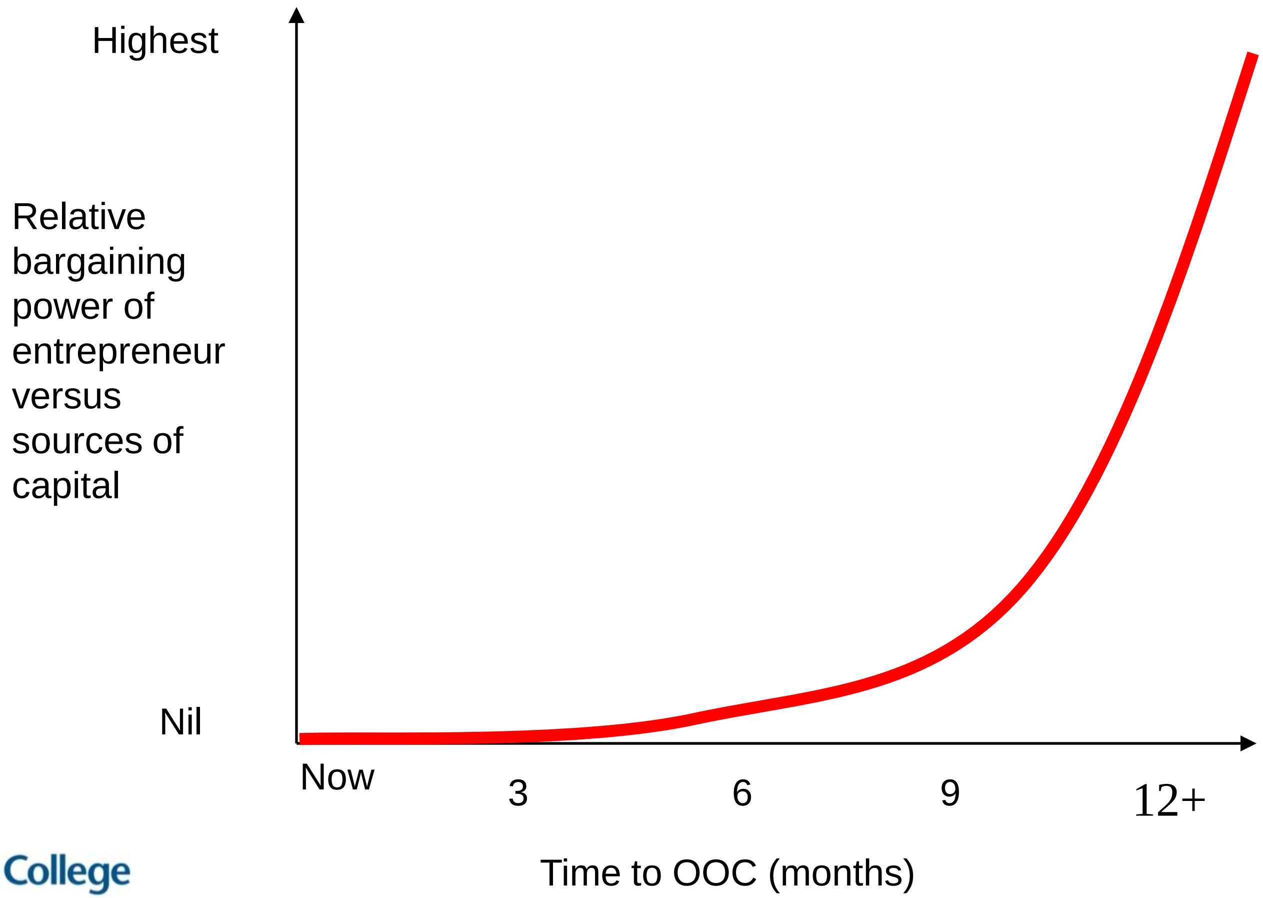
Your bargaining power based on time to 'out of cash' (OOC)



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Time to Close (TTC)

How long does it take to 'close the deal'?

- Equity- Formal/Informal
- Debt - Secured/Unsecured
- Off Balance Sheet (leasing/contract hire)

It <u>always</u> takes longer than you anticipate!!

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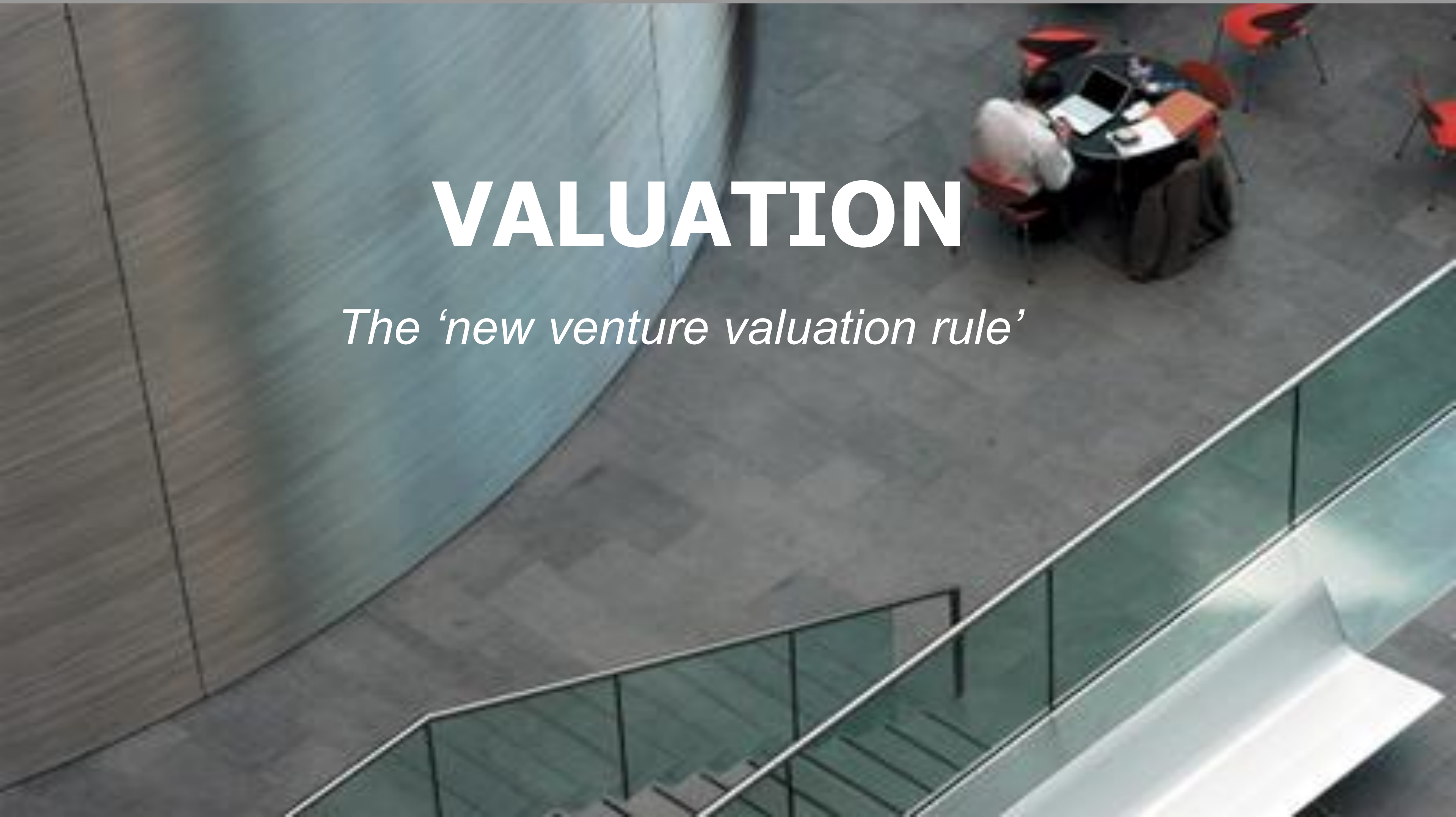

VALUATION

The 'new venture valuation rule'

The new venture valuation ‘rule’

Most VCs wish to **exit by year 5** (the target year)

The **annual rate of return** required (discount rate) will depend on the level of perceived risk. Let’s call it **45%**

The multiple (M) of the investment required by the investor is simply calculated as follows:

$$M = (1 + \text{annual rate of return})^{\text{the target year}}$$

Thus $M = (1 + 0.45)^5 = \mathbf{6.41}$

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The **capital return (CR)** is simply the multiple (M) times the original investment (**I**). Lets call **I** £1.1m giving us:

CR = 6.41 x 1.1 = **£7.05m**

The percentage ownership (PO) expected by the investor will be:

$$PO = \frac{\text{Capital Return}}{\text{Market Valuation (in target year)}} \times 100\%$$

Our task is now to estimate a **market value (MV)** in year 5 (the target year). The most common way of doing this is to use the **price to earnings ratio (PE)** for comparative firms. Thus:

Market value = PE x projected earnings in target year (NPBIT)

Let’s assume that the PE ratio for similar quoted firms is 16 and that **projected NPBIT** in year 5 is £1m

The **unadjusted Market Value** in year 5 is thus 16 x £1.0m = **£16.0m**

The required percentage ownership is, therefore:

$$\frac{7.05}{16.00} \times 100\% = \mathbf{44.0\%}$$

In practice, however, the PE of quoted companies may be subject to a discount by the investor. This can easily amount to **30%** but is a matter for negotiation….Thus:

PE (adjusted) = PE – (PE x discount rate)

So

PE (adjusted) = 16 – (16 x 0.30) = 11.20

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Thus, if a discount rate of 30% is applied the percentage ownership required rises:

$$\frac{7.05}{11.20} \times 100\% = \mathbf{62.9\%}$$

Therefore, it is in your interests to persuade the investor that:

1. The risks (managerial, market, industry and technological) are low so that the required annual rate of return (which reflects financial risk) can be reduced
2. That earnings in the target year are realistic so as to avoid too heavy a discount
3. That the PE ratio is indeed comparable.

Ultimately, the value of the business is only established by what someone is prepared to pay…

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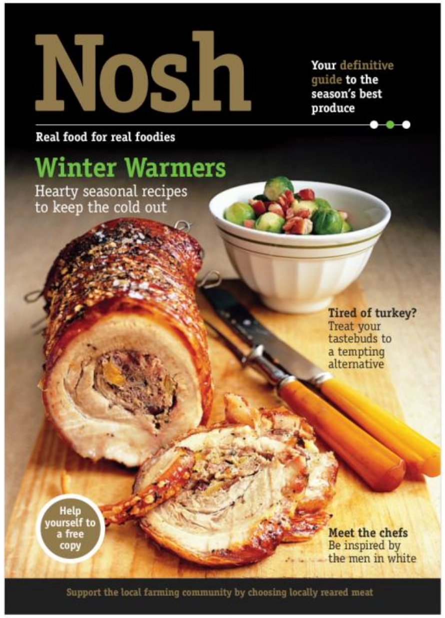
Structuring Equity Investments



Nosh Ltd.

The business was founded in 2005 with 10000 shares split between Liz (7000) and Simon (3000)

At this point we *do not know the value* of these shares…

The share price (or value) of an unquoted company is only known at the time the deal is done…

After 18 months an investor, Bob, offers to invest £18,000 in return for a 45% equity stake in the business.

Structuring the deal:

Stage 1. The first step is to calculate the **pre-money valuation** (its value before the investment is made):

Pre-Money Value = Amount of investment x (1 – equity stake)/equity stake

So:

£18,000 x (1-0.45)/0.45 = **£22,000**

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Stage 2. We now need to calculate the **value of each share** which is simply:

Pre-money valuation/number of shares. So, £22,000/10000 = **£2.20**

Note: The share price (or value) of an unquoted company is only known at the time the deal is done…

You need to understand that equity investments are negotiated in percentages (e.g. 45% for £18,000) but structured using shares.

When a business raises money by selling equity it issues new shares to the investor. The investor does not take a proportion of the shares that already exist (e.g. 45% of 10,000 shares)

Stage 3. Calculate the **number of new shares** to be issued. The deal share price is £2.20 and £18,000 is being invested. The number of new shares will, therefore be: £18,000/£2.20 = **8182**

The total number of shares is now 10,000 + 8182 = 18182

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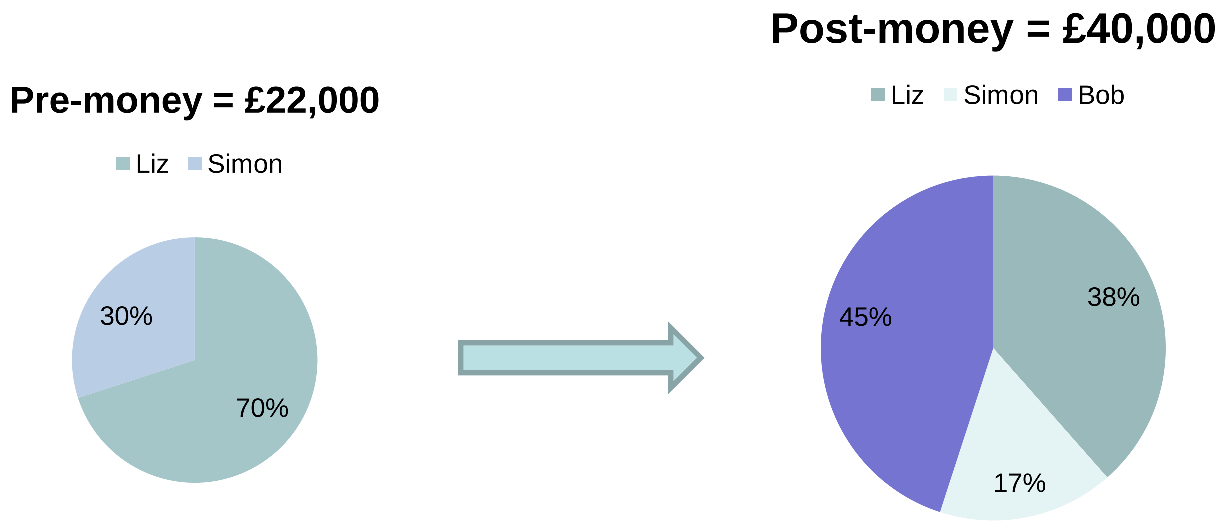

In summary:

1.Calculate the 'pre-money valuation'

2. Calculate the deal share price by dividing the pre-money valuation by the number of shares

3. Determine the number of new shares to be issued by dividing the investment amount by the deal share price.

Second round investment

In early 2009 Liz, Simon and Bob agreed to sell 30% of the equity in Nosh to Johnston Press for £165,000

Structuring the deal:

Stage 1. Calculate the **pre-money valuation** (its value before the investment is made):

Pre-Money Value = Amount of investment x (1 – equity stake)/equity stake

So:

£165,000 x (1-0.30)/0.30 = **£385,000**

Stage 2. Calculate the **deal share price**

Pre-Money Value /number of shares = £385,000/18182

Deal share price is therefore £21.17

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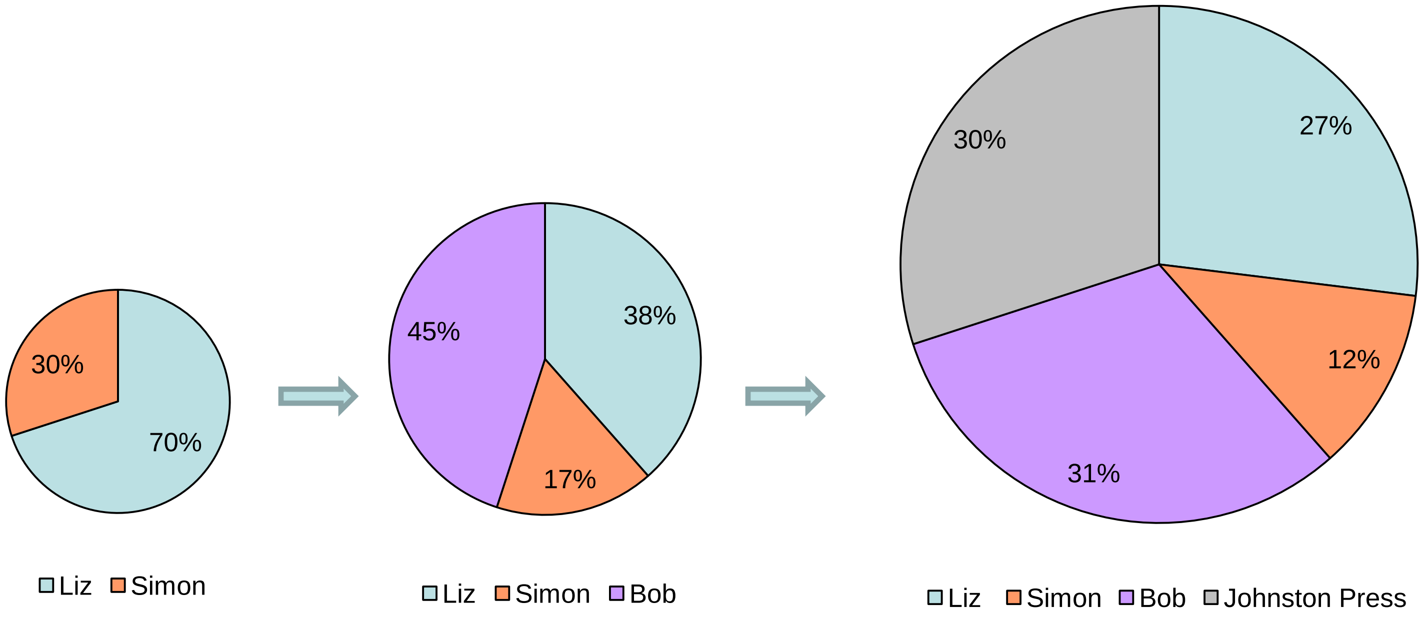
Stage 3. Calculate the **<u>number of new shares to be issued</u>**

Investment amount/deal share price = £165,000/21.17

Number of shares issued to Johnston Press = 7792



£22,000 £40,000 £550,000

Bob is happy because his £18,000 is now worth £170,500 even though his ownership share has been diluted from 45% to 31%

Early stage

Equity Finance

Sources of Equity

- Your personal wealth (savings, equity in house) and that of business partners
- Family (‘Love money’)
- Venture capital
- Business Angels
- Corporate partners

Business Angels

- Wealthy private investors, often experienced entrepreneurs
- *Usually* want hands-on involvement in a sector that they understand
- £10-£250k is usual investment (some angels and angel syndicates may do more)
- Use their friends and networks to spot opportunities
- There are approximately 18,000 active angels in the UK and >200,000 in the USA

www.eban.org
www.bbaa.org.uk

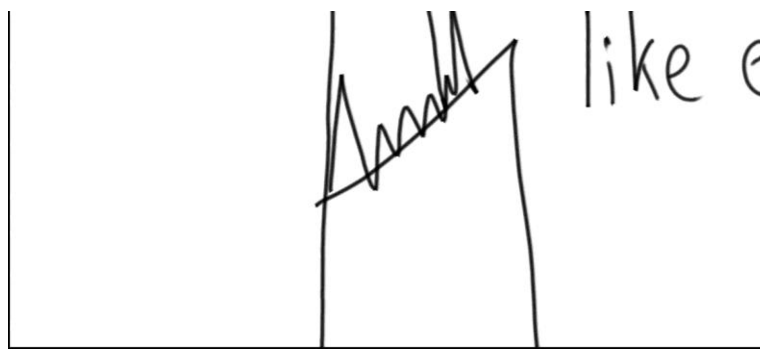
Venture Capital

www.bvca.co.uk
www.evca.eu
www.nvca.org

So...you want to raise venture capital?

"My name is Rupert and I am very gifted...
Although I am cultivated I am utterly ruthless
You are not my customer,
You are not my friend,
I do not care about you or your hirelings
If you fail me I WILL ruin you...

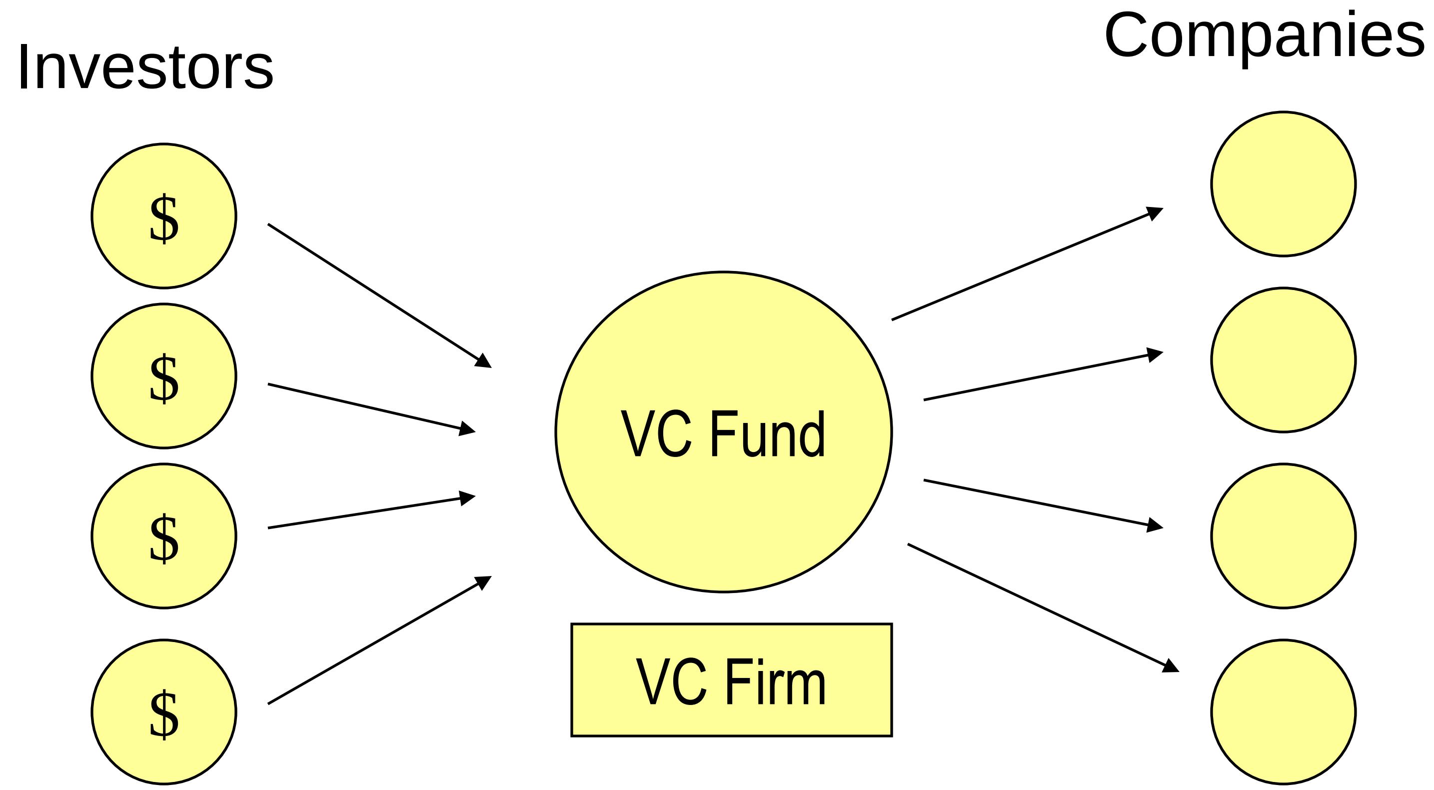
Now...how may I help you?"



Venture Capital - Some basics

- Equity is invested in *stages* or *rounds* (seed, start-up, expansion, etc)
- Targets and milestones are set by VCs at each stage
- Deal structures vary widely, *you need to take professional advice*
- Some terms can be 'amusing' – e.g. WaySearch
- The VC firm may or may not require a controlling share, they may be able to fire you!

Venture Capitalists are Intermediaries



e.g. Investment banks, pension funds, wealthy individuals

e.g. Amazon.com, e-trade, TurboGenset

The Venture Capital Cycle

<u>Investors in fund:</u>

- Pension funds
- Investment funds
- Wealthy individuals

Fund
$100m

5-10 years

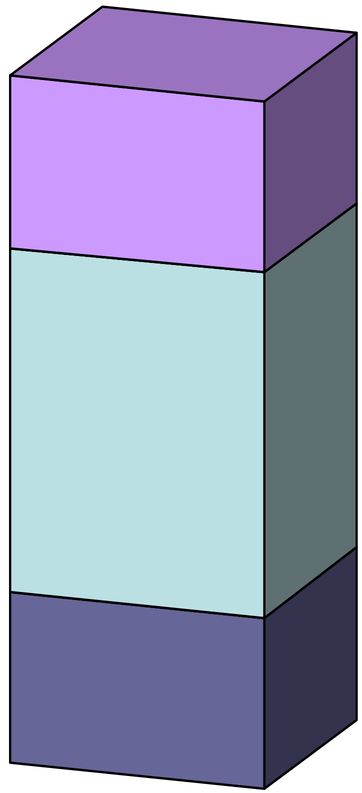
$1bn

<u>Return distributed as cash or shares</u>

VC firm raises, invests and manages fund

VC firm keeps 20% of any return over 100% (Carried Interest)
+ charges a management fee

Even VCs don’t see 100% success



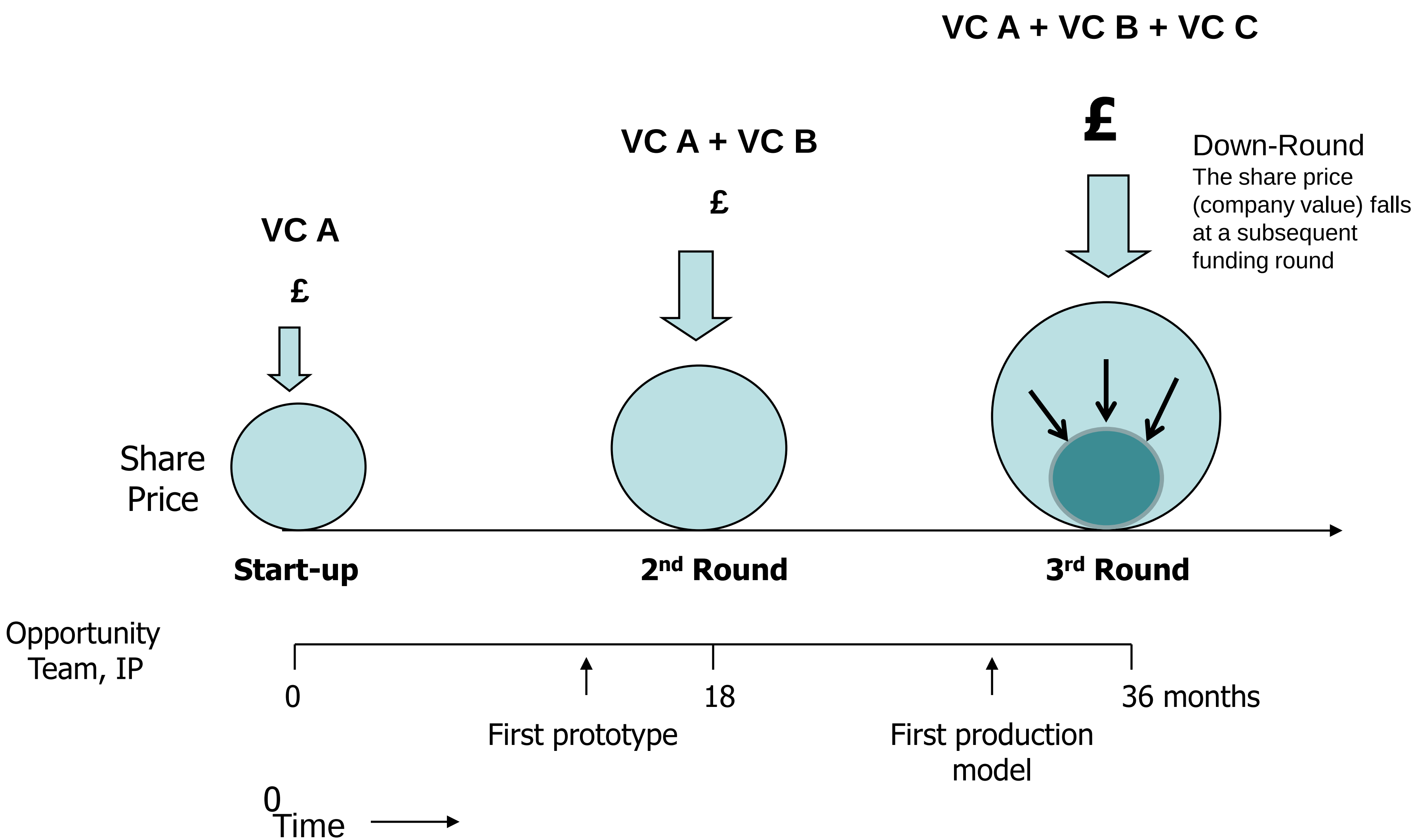
⇦ **20-30% big winners (Payday…)**

⇦ **50% ‘Living Dead’ (money back?)**

⇦ **20-30% failures (total loss!)**

High risk = High expected returns
(e.g. 60% ARR for early stage investments)

Investment Lifecycle of a Start-up



VCs think in milestones…and dream of EXITS

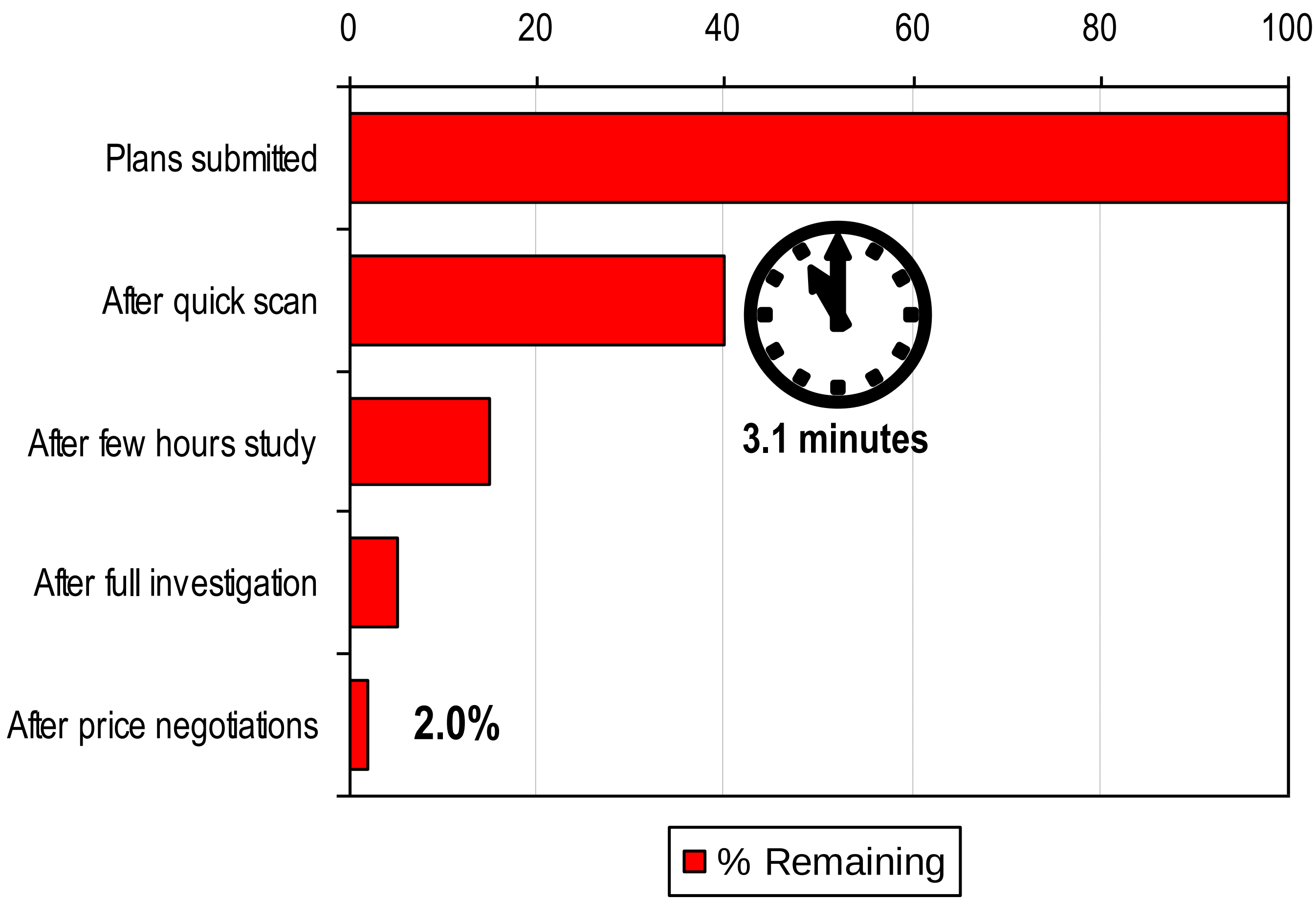
“Nobody makes real money until the exit”

What VCs *tell us* they look for….

- **Clean IP portfolio** - Especially in early stage tech firms
- **Sector** - Investors back what they know (so check out their portfolio). They also learn from their mistakes.
- **Financial indicators** - Gross margin is a favourite
- **Entry valuation** - typically 30% less than an equivalent quoted company (a black art…)
- **Exit route** - can I get out? When? How much will it be worth? (also a black art..)
- **Due diligence** - any skeletons?
- **The team** - especially positive if they have worked together successfully before

But in reality it depends on individual heuristics and biases....

Attrition rate of plans submitted to VCs



Top deal killers…

- Poor quality management - leave positions vacant rather than recruit the wrong people
- Insufficient market size – the best plans address huge opportunities
- Insufficient “critical mass” to the technology - VCs will not back a one-shot wonder
- Problems with intellectual property portfolio

But….It depends heavily on the heuristics and biases of the investor

The voice of experience:

What some entrepreneurs have said….

“Overall, it is the most soul-destroying, degrading process any entrepreneur is likely to go through, when rejection becomes part of daily life….there is a sort of Darwinian logic to the whole process”.

"VCs are, as a group, unprofessional, rude and frequently unintelligent. I've never met a bigger bunch of so-called professionals who in reality are cretins, with perhaps the exception of estate agents and head-hunters".

“Securing VC funding is bloody hard work. VCs are a cross between weasels and lemmings”.

Debt Finance

CAMPARI : The Banker’s Maxim

- **Character** - ‘respectable & trustworthy’
- **Ability** - track record, team, potential
- **Margin** - % above base rate
- **Purpose** - expansion, rescue or buying toys
- **Amount** - is this realistic, too much or too little?
- **Repayment** - can you pay the interest *and* repay the principal
- **Insurance** - if required, is there security?

‘Honest, open and timely communication is the key to building a relationship with your bankers. Bankers HATE surprises’!